No. 2827

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of CREECH BROTHERS LUMBER COMPANY, a corporation,

Bankrupt.

UPON APPEAL AND REVIEW FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

BRIEF OF APPELLANT AND PETITIONER FOR REVIEW

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STATEMENT.

This is an appeal from, and petition to revise in matter of law, an order of the United States District Court for the Western District of Washington, Southern Division, allowing to H. W. MacPhail a preferred claim against the bankrupt estate of

Creech Brothers Lumber Company, a corporation. The facts are as follows:

THE "ASSIGNMENT" TO MACPHAIL.

On and before October 29, 1912, Creech Brothers Lumber Company was operating a mill and engaged in the manufacture of lumber at Raymond, Pacific County, Washington (57). The company had become insolvent (57). On that date it executed to H. W. MacPhail the conveyance or assignment under which he now claims priority. This is attached as Exhibit A to MacPhail's proof of claim (22). The substance of it is set forth at page 11, *post.*

The construction and validity of this instrument are the principal questions involved in this appeal. They will be fully discussed later. For the present it is enough to say that it purported to assign and transfer all of the property, real and personal, of the Lumber Company to MacPhail, giving him full power to sell and dispose of it and to use the money for the purpose of paying the indebtedness of the corporation or for operating expenses or any other purpose for which he might see fit to use it. It was contemplated that MacPhail should make certain loans to the company. As to

these he was given a right of reimbursement from two sources:

(a) *from profits.*

(b) from the sale of the assets *by him.*

His operations showed no profits, but a loss (46); and he did not sell the assets (46, 47).

This instrument was signed by the officers of the Lumber Company but was not acknowledged. It was not recorded (46, 60).

Assent by Creditors.

At or about the same time certain creditors of the Lumber Company signed an agreement containing certain waivers. Four copies of this agreement were signed by different sets of creditors. These are designated as Exhibits B-1, B-2, B-3, and B-4, in claimant's proof of claim, but inasmuch as all four are identical and are so described in the proof of claim, we have brought to this court only B-1 in full (27), and the lists of creditors whose names were affixed to B-2, B-3, and B-4 (31, 32). The construction of these creditors' agreements is one of the principal questions involved in this appeal. They provided in substance that in consideration of the assignment to MacPhail and

his agreement to finance the plant ,the creditors who signed these instruments would agree to two things: (1) *to extend the time of payment* of their claims; and (2) *to desist from pressing them* in the courts or otherwise *as long as the plant was operated at a monthly net profit of $1,000 or more.*

They did not assent to MacPhail's having any lien whatever.

MacPhail's Operations and Advances.

MacPhail took charge of the plant under the instrument above referred to and operated it at intervals until August, 1913 (37, 59). According to MacPhail's manager, the plant showed a profit of $1,000 or more per month from February to June 1, 1913 (37, 59). MacPhail entered into a contract for quite a large shipment of lumber, but on account of a break in prices of other lumber not called for in this particular order, but which had to be manufactured at the same time in order to make a profit, a heavy loss was experienced (39, 59). *The net result of MacPhail's operations was that the estate lost money* (40, 46). This so far as the record shows was not due to any negligence or mismanagement on his part, and apparently the plant was conducted in the ordinary and usual manner (36).

MacPhail continued in charge of the property of the bankrupt until the appointment of a receiver for the company in a suit in the Superior Court of the State of Washington for Pacific County. This occurred on July 28, 1914 (7). On August 27, 1914, a petition in involuntary bankruptcy was filed against the Lumber Company and adjudication followed on November 16, 1914 (46, 2). On December 28, 1914, Robert G. Chambers was appointed trustee in bankruptcy for the Lumber Company and is still its trustee (47).

The property of the company was not sold by MacPhail, but was sold in the bankruptcy proceedings, the amount realized being less than enough to pay MacPhail's preferred claim. Some $137,000 in claims have been proved against the estate (47).

At various times during the course of MacPhail's operations he advanced sums of money to the Lumber Company and made certain payments from the Lumber Company to himself upon account. These payments are tabulated in Exhibits C and D attached to MacPhail's proof of claim (33-35). The sums set forth in Exhibit C (35) in the column headed "Assignee" under "Receipts" and "Expenditures" respectively show payments from and to MacPhail (40). It will be noted that in July,

1914, as shown by Exhibit C, MacPhail received a payment from the company of $1,171.93, and in April of $319.97. The bankruptcy petition was filed in August. Therefore unless MacPhail's claim is preferred, he can prove no claim at all without the surrender of these payments, of which the July payment at least is clearly preferential. MacPhail admits that certain indebtedness was contracted in the name of the corporation which was not paid by him, *which is still a claim against the company* (45).

He advanced, he states, in excess of sums received from the company, the sum of $13,877.74, upon which he claims interest in the sum of $1,292.98, as itemized in Exhibit D attached to his proof of claim, making a total sum of $15,170.69, for which he claims priority.

Not All Creditors Assented.

Some contention was made in the courts below that all of the creditors of the Creech Brothers Lumber Company signed the Exhibits B above referred to. This, as we shall later show, is immaterial if true. But it is not true. The schedules of the bankrupt filed in the bankruptcy court on December 9, 1914, (52-57) showed some nineteen creditors whose names do not appear in the lists of as-

senting creditors attached to Exhibits B. For the convenience of the court we here enumerate those creditors: W. S. Applegate, P. W. Rhodes, W. R. Johnson, Calhoun, Denny & Ewing, Bell Bros. Hardware Co. (this copartnership was one of the petitioning creditors who instituted these bankruptcy proceedings), Standard Towboat Co., James Churchill Glove Co., Portland Machinery Co., Allis-Chalmers Mfg. Co., Great Western Smelting Co., Mill & Mine Supply Co., E. C. Atkins & Co., South Bend Mills & Timber Co., Mrs. Bertha C. Stringer, Benson Office Supply Co., Raymond Livery & Garage, Transit Towboat Co., B. F. Armstrong, and H. H. Powelson.

It appears from the evidence that it would have been impossible to obtain a complete list of the creditors of the company at the time these agreements were executed, because as MacPhail's own manager testifies (42), the affairs of the corporation were in such shape at the time they took charge *that it was impossible to tell to whom or in what amounts the company was indebted.* This matter we do not deem important, but as it is a fiction which was pressed with some earnestness in the court below, we think it is necessary to have the actual facts before this court.

Proceedings in the Courts Below.

The trustee in bankrutpcy refused, upon demand, to file objections to MacPhail's preferred claim. A. R. Titlow, receiver of the United States National Bank, a creditor of the estate in the sum of $16,255.75 (48), thereupon obtained leave of the bankruptcy court to make such objections in the trustee's name. These facts are recited both in the orders of the Referee and of the District Court hereinafter referred to. A hearing was had before the Referee upon the objections, and on October 6, 1915, an order was entered disallowing the claim both as a general and as a preferred claim, but without prejudice to the right to prove a general claim, or the trustee's right to recover preferences (50). MacPhail then petitioned for review by the District Court, and on the 12th day of June, 1916, that court entered an order reversing the Referee and allowing priority to the claim in the principal amount claimed, namely, $13,877.74 (65). The claim for interest was rejected.

Receiver Titlow again made written demand upon the trustee in bankruptcy to take such proceedings as might be necessary to obtain a review by this court of the District Court's order (67). Upon the trustee's failure to take such proceedings,

the objecting creditor, on next to the last day upon which an appeal could be taken, after notice to the trustee, applied to the District Court and obtained permission to take such proceedings in the name and stead of the trustee (69), but did not actually appeal until the very last day of the period for appeal under the ten-day statute. Being somewhat in doubt as to the correct procedure for obtaining a review of the District Court's order, he has brought the case to this court both by petition for review and by appeal. This practice has been approved by this court. *Chavelle vs. Washington Trust Co.,* 226 Fed. 400.

Questions of Law Involved.

It will contribute somewhat to clearness in the presentation of the questions involved to state the respective contentions of the parties *pro* and *con* with respect to the claim. Counsel for claimant argues that the conveyance to MacPhail was an assignment for the benefit of creditors, and that the claimant on that account is entitled to priority for the loans which he made to the bankrupt. *The principal contention,* however, is that MacPhail, under the so-called assignment to him from the bankrupt, was given a right to a *general lien* against its assets, and that all the creditors *assented* to his having such lien.

This is not true as we have previously pointed out (*supra,* p. 6).

On the other hand, it is our contention: (1) that this was a fraudulent conveyance, and not an assignment for the benefit of creditors; and if it were such an assignment, no right of priority would thereby be conferred for advances such as these; (2) that under the assignment to MacPhail no general right of lien was given; (3) that none of the creditors assented to his having a lien of any sort on the assets of the company; (4) that the instrument, not being recorded, executed, or acknowledged in accordance with the statutes of Washington, *cannot confer a lien as against the trustee in bankruptcy or the creditors.*

Specification of Errors.

1. The District Court erred in finding and adjudging that MacPhail was entitled to a preferred claim in any sum whatever, for the reasons hereinbefore stated.

2. The District Court erred in finding and adjudging that MacPhail was entitled to any claim whatever, since the proof showed that he had received unlawful preferences which had not been surrendered.

ARGUMENT.

MacPhail's claim can be sustained only by making various assumptions both of law and fact which we believe to be erroneous. The first of these is as to the *validity and effect of the instrument* under which his rights are asserted. If the effect of this instrument is not such as he conceives it to be, or if it be invalid, claimant's rights are concluded at the very threshold of the case; while, as we shall show later, even if the instrument has the effect which he supposes, this does not by any means determine the case in his favor; there are other elements in the case sufficient to defeat him.

The Conveyance to MacPhail.

(*a*) *Its Illegality.*

We have already briefly referred to this instrument (p. 2, *supra*). We will now analyze it more fully. (See pp. 22-26.) After reciting the insolvency of the Lumber Company, and that MacPhail is willing to finance its operation if he be protected for advances, and if the creditors will extend the time of payment of their claims, MacPhail is appointed the *agent* of the Lumber Company to take charge of all its property, and the company sells, transfers and assigns to MacPhail all its prop-

erty, real and personal, with authority to dispose of it and to use the proceeds for the "purpose of paying the indebtedness of said corporation or the operating expense, *or any other purpose for which he may deem best,* or for the purpose of enlarging, adding to or repairing said mill plant; also the right and authority *to borrow money or otherwise contract indebtedness in the name of said corporation,*" and to purchase logs, employ labor, etc., *for cash or on credit.* The instrument further states that it is understood that any sums advanced by MacPhail, or any indebtedness he may contract in operation or in the purchase of logs, etc., shall be a first and prior *lien* to be paid before any sums due the creditors. The court will note here *the absence of any statement as to what the lien shall be on.* We will refer to this later (p. 24).

It is further provided that MacPhail will, as the company's agent, operate the mill in the name of the corporation as long as it can be operated at a net profit of $1,000 or more per month, and that *from the profits* derived from the operation of the plant, he shall first reimburse himself for any sums advanced by him, and shall next pay any indebtedness which he may have contracted, the remainder to go to creditors. The next paragraph

gives MacPhail the *option* to cease operating the plant in case it shall not clear $1,000 per month, and to sell the property for the purpose of *first reimbursing himself* for any sums advanced by him, or any sums contracted by him in the operation of the plant, and second to pay the creditors.

Under this instrument MacPhail asserts a general lien against the bankrupt's assets. We propose to show that if the instrument does confer this broad right of lien, *it is absolutely null and void.* This for two reasons: *first,* it is violative of the trust fund theory as to the assets of insolvent corporations recognized by the law of the State of Washington; *second,* it is a fraudulent conveyance, hindering and delaying creditors.

1. *As to the trust fund theory.* The doctrine that the assets of an insolvent corporation are a trust fund for the equal benefit of all its creditors is too well established in the State of Washington to require extended discussion or citation. It was first enunciated in the early case of *Thompson vs. Huron Lumber Co.,* 4 Wash. 600, and has become the settled law of this state.

It is true that the doctrine is most commonly applied to preferential transfers or mortgages to

secure antecedent debts. But it has a broader application. The aspect of it which we wish to emphasize here is that it is not the policy of the law of this state to permit the indefinite prolongation of dying corporations, or the indefinite continuance of the corporate business when hope of success of the venture has been really abandoned.

Thus, in the *Huron Lumber Co.* case, 4 Wash. 600, 603, the court says, referring to a provision in a corporate mortgage whereby the corporation was permitted to prosecute its ordinary business for an indefinite time:

"This will not do in the case of an insolvent corporation, no matter what the good faith of its creditor is. *When it has reached a point where its debts are equal to or greater than its property, and it cannot pay in the ordinary course, and its business is no longer profitable, it ought to be wound up and its assets distributed.* Therefore no device can receive the countenance of the courts which provides for an indefinite continuance of its corporate life under the protection of a mortgage, against the protest of those who are entitled to share in its property, be it much or little. *The hindrance and delay contemplated by the terms of the instrument ought to render it null and void.*"

Can the provisions of the so-called assignment to MacPhail be reconciled with this salutary rule of public policy? Here is an instrument which does not require the winding up of the insolvent corpora-

tion's business, *but permits its indefinite prolongation.* It does not require the payment of debts, *but permits the imposition of new ones* upon the already overburdened assets. Further, these new obligations, at least so far as they are owing to MacPhail or represent debts for which he has become chargeable, *are to rank ahead of outstanding obligations. MacPhail is not even required to use any money which may come into his hands for the purpose of paying debts at all.* He is allowed to use it "for any other purpose for which he may deem best." No limitation whatsoever is placed upon his duties or obligations. This trust fund of creditors is turned over to MacPhail for the purpose of speculation and squandering *ad libitum.* It is an attempt to confer upon MacPhail powers which no one would contend *that the corporation itself had,* for clearly it could not so alienate this trust estate from its lawful beneficiaries. An arrangement more obviously void and inimical to public policy can scarcely be conceived.

2. *As to its being a fraudulent conveyance.* For reasons other than those having their origin in any doctrine peculiar to the law governing corporations, *it is a fraudulent conveyance,* irrespective of the intention of the parties to it.

Let us again notice its provisions. In the *first* place it purports to divest the corporation of *title.* Where are creditors to look for payment? They cannot resort to the ordinary legal processes for collecting their claims, for the corporation no longer has assets. They must look for payment to this benevolent gentleman *whose lien is prior to theirs; second,* this instrument not only imposes no limitation upon MacPhail's authority in disposing of the company's property, but, as above noted, expressly authorizes him to use its assets "for any other purpose for which he may deem best." Under this provision he can divert the funds coming into his hands to any purpose, or launch out into new ventures until all the property turned over to him has been dissipated; *third,* it empowers him to create new indebtedness which shall be a lien prior to existing claims.

The obvious result of all these provisions is to hinder and delay creditors. This, under all of the authorities, constitutes a fraudulent conveyance.

In *Dearing vs. McKinnon Hardware Co.,* 58 N. E. 773, the New York Court of Appeals had before it a purported mortgage given by an insolvent to a trustee, which provided that it should operate only in favor of those assenting to its terms, and

required an extension of payment for ninety days on the part of creditors, and placed the property of the mortgagor beyond the reach of creditors. The court says (p. 776):

"An insolvent corporation, under the protection of this ingenious instrument, is permitted to keep possession of all its property, to continue its business, to buy, manufacture, and sell 'in the usual course of trade,' which admits of sales on credit, and the creditors, whether preferred or unpreferred, unless they are willing to let this condition of affairs continue for 90 days, and tie their own hands by an extension of time for the payment of their debts, must lose all benefit from the mortgage, and every chance of having their debts paid out of the assets of the mortgagor until a surplus, after paying all assenting creditors, should come back into its possession. There was not even a promise by the mortgagor to pay the proceeds of sales to the trustee, although the latter was 'authorized and empowered to receive' them. Thus the mortgagor could keep its creditors at bay for 90 days, and continue in the possession and use of its property during that period. The inevitable result would be to hinder and delay creditors in violation of law."

The case at bar is much stronger. Here the property of the corporation was to be kept away from creditors not for 90 days, as in the New York case, *but forever.* The instrument involved in the case at bar also, it will be observed, gives the trustee much greater latitude in respect to disposing of the property and creating new and prior liabilities than was given by the mortgage in the New York case.

A similar conveyance was before the Supreme Court of Michigan in *Pettybone vs. Byrne,* 56 N. W. 236, where a lumber company, heavily indebted, gave a conveyance of its property to a trustee, empowering him to take possession, carry on the business, borrow money, etc. The court says (p. 239):

"The instrument in question * * * operated as a fraud on the creditors who had not accepted the benefits of the trust. It is not a mortgage, merely, for the reason that the property is conveyed absolutely to the trustee, *and is beyond the reach of the creditors.*"

Again, in *Jenkins vs. John Good Cordage Co.,* 68 N. Y. S. 239; 56 App. Div. 573, affirmed 61 N. E. 1130, an insolvent corporation gave a mortgage to a trustee to secure its indebtedness, creditors being required to exchange the corporation's notes which they held for bonds under this corporate mortgage. The instrument was held a fraudulent conveyance, since the only recourse left to non-assenting creditors would be a right to levy upon a worthless equity.

Again we find the instrument before the court surpassing all precedent in illegality. For here not even an *equity* was left to creditors, since the *title* was purported to be conveyed to MacPhail.

We believe further amplification of authorities unnecessary. The following are apposite:

Wood vs. Eldredge, 111 N. W. 168 (Mich.).
Volentine vs. Hurd, 21 Fed. 749 (C. C. Vt.).
DeWolf vs. Sprague Mfg. Co., 49 Conn. 282.
Gregg vs. Cleveland, 17 S. W. 777 (Texas).
McDonald vs. Hoover, 44 S. W. 334 (Mo.).
Hungerford vs. Greengard, 69 S. W. 602 (Mo.).
Thompson vs. Huron Lumber Co., 4 Wash. 600.

A further point is so closely related to the topic now under discussion that we will notice it briefly here. It was claimant's contention that the instrument in question is an assignment for the benefit of creditors. In showing that it is not such an assignment we possibly anticipate matter more properly reserved for reply. But in making this negative showing we shall at the same time advance our affirmative argument upon the point that this is a fraudulent conveyance.

Not an Assignment for Creditors.

Judge Sanborn, in *Missouri American Electric Co. vs. Hamilton Shoe Co.,* 165 Fed. 283, 288, defines an assignment for the benefit of creditors as "a conveyance by a debtor, without consideration from the grantee, of substantially all of his property in trust, to collect the amounts owing to him, to sell and

convey the property, to distribute the proceeds of all the property among his creditors, and to return the surplus, if any, to the debtor."

In 5 Enc. L. & Pr. 1005, it is defined as "a transfer without compulsion of law by a debtor of his property to an assignee or trustee, in trust, to apply the same or the proceeds thereof to the payment of his debts, and to return the surplus, if any, to the debtor."

The purpose of such an assignment, it will be seen, is to bring about the application of the debtor's property, with such speed as is consistent with the interests of creditors, to the payment of his debts. Any provisions, therefore, such as a provision for the *indefinite carrying on of the business* of the debtor, the *creation of new liabilities,* or the *imposition of new burdens upon the debtor's property,* tend to defeat the very ends which the assignment is intended to subserve, and render it null and void.

The deed of assignment in question contains all of these objectionable features. The most extraordinary powers are conferred upon this trustee. In addition to his authority to use the money obtained from the sale of the debtor's property for "any other purpose for which he may deem best," he is

empowered to use it "for the purpose of enlarging, adding to or repairing said mill plant; also the right and authority to borrow money or otherwise contract indebtedness in the name of said corporation," and to purchase logs, employ labor, etc., for cash or *on credit.* It is provided that if the plant does not clear the sum of $1,000 per month, that the trustee may *at his option* cease to operate the plant and sell the property. The instrument thus leaves it entirely optional with the trustee whether he will continue the operation of the plant *even though it were being operated at an actual loss.* Further, all that he advances *or becomes liable for* is to be *a prior lien.*

Provisions much less extreme than the foregoing are uniformly held to invalidate assignments irrespective of any actual fraudulent intent on the part either of the assignee or the assignor. A leading case is *Jones vs. Syer,* 52 Md. 211; 36 Am. Rep. 366. The assignment empowered the trustee "to carry on and conduct said business in his discretion for such time as in his judgment it shall be beneficial to do so, or to sell all of said goods and stock in trade and property at such times, in such manner and for such prices as he may deem proper, and to apply the proceeds," etc. The court says:

"It is obvious the certain effect of this clause would be to hinder and delay creditors, and as against them such provisions render the deed utterly void."

In *Dunham vs. Waterman,* 17 N. Y. 9, it was held that a provision in an assignment authorizing the assignees to complete the manufacture of certain unfinished machinery and materials in process of manufacture, at the expense of the assigned fund, as in their judgment might be advisable, so as to realize the greatest amount of money therefrom, renders an assignment fraudulent and void on its face, though an actual fraudulent intent was disproved.

In *Bodley vs. Robbins,* 7 Howard, 276; 12 L. Ed. 699, a deed of assignment by a banking and railroad corporation recited the embarrassed situation of the company and its inability to pay its debts, and purported to assign its property to trustees who were authorized to borrow $250,000 for the purpose of completing the company's railroad, to allow claims against the corporation, and out of the proceeds of the sale of its assets to first pay the principal and interest of the above loan, the balance to be distributed *pro rata* among creditors. The court says (p. 278):

"Upon its face this deed shows an intention by the bank *to postpone its creditors,* use the effects of

the bank for the completion of the railroad, pay the trustees enormous salaries, and make no dividend among the creditors of the bank until these objects are accomplished. This was proposed to be done with the consent of creditors, and if that consent had been given, there could be no objection to the arrangement. But the plaintiff * * * did not consent; consequently he was not bound by the deed of assignment. *It was fraudulent as against him and all other creditors of the bank who did not become parties to the deed.*"

Further authorities construing purported assignments similar to but less obviously illegal than that under discussion as fraudulent conveyances are the following:

Webb vs. Armistead, 26 Fed. 70 (C. C. Va.).
Cott vs. Knabe & Co., 26 S. E. 246 (Va.).
Gardner vs. Commercial Nat. Bank, 95 Ill. 298, 308.
Planck vs. Schermerhorn, 3 Barb. Ch. 644.
Inloes vs. American Exchange Bank, 11 Md. 173; 69 Am. Dec. 190.

We have thus shown that the so-called assignment to MacPhail is void (1) as *impairing the implied trust for creditors* under which the assets of an insolvent corporation are held; (2) *as a fraudulent conveyance,* whether it be regarded as a mortgage or as an assignment for creditors.

THE CONVEYANCE TO MACPHAIL (Continued).

(*b*) *Its Construction.*

We do not think, however, that the instrument in question purports to give MacPhail a general lien at all. The material portions of it have been set out, *supra,* p. 11. What is its real *meaning?*

It will be observed that MacPhail was given the right *as against the bankrupt* to reimburse himself out of two possible funds to be derived either (1) *from the profits* made by the plant under his management, or (2) from the moneys realized upon the *sale* of the assets *by him.* Neither event has occurred. He did not make any profits. On the contrary, he admits that the plant lost money under his management (40, 46); and he did not sell the property. We think, therefore, that irrespective of the illegality of the instrument, its defective form, and the failure to record it, *under MacPhail's agreement with the bankrupt,* even leaving also out of consideration for the moment the question of assent or non-assent of creditors, he is not entitled to claim a lien.

The claimant is then driven into this distressing situation. The validity of the instrument can be sustained only by adopting the narrow construction

giving him a prior right of reimbursement only *out of profits.* But this construction does him no good, for there were no profits. He must therefore contend for a *general lien;* but this construction renders the instrument null and void.

We are willing to leave it to MacPhail to elect which horn of the dilemma he desires to impale himself upon. The result will be equally fatal in either case.

For the purpose of the discussion as to the validity of the instrument, we have *assumed* what we will now prove to be *the fact,* (if it be material) that *no creditors assented* to the arrangement between the bankrupt and MacPhail. *Some* of the creditors did sign a certain paper. But the agreement therein contained was *entirely different* than MacPhail and the bankrupt had agreed upon. We have already referred to this briefly, *supra,* p. 3. We will now discuss it more fully.

Extent to Which the Creditors Assented.

Now turning to the Exhibits B attached to claimant's petition, we find a very limited consent even on the part of the creditors who signed those papers. These instruments (see Exhibit B-1, p. 27) recite insolvency of the Lumber Company and

that its stockholders and trustees have agreed to make an assignment to MacPhail for the benefit of creditors and that "whereas the said H. W. MacPhail has agreed to operate said plant as assignee and purchase logs for that purpose, and otherwise finance the operation of the same, *provided the same can be operated at a profit,* and also *provided the creditors will extend the time of payment of their several accounts,* and desist from pressing said accounts until they can be paid by the profits derived from the operation of said plant."

It is then provided that the creditors signing the instrument agree:

"That they will *extend the time of payment of our* several claims and *desist from further pressing* said claims in the courts or otherwise, *so long as said plant is operated at a monthly net profit of $1,000 or more per month.* It being understood that *in the operation of said plant* that the said MacPhail shall first pay the cost of operation and all sums contracted by him as such assignee and all sums advanced by him, and further shall pay to the creditors," etc.

The court will observe that the only agreement on the part of the assenting creditors was (1) *to extend the time of payment* of their claims; (2) *to desist from further pressing* their claims. But this agreement to "extend time" and "desist from pressing" was by its terms *limited to such time as*

the plant could be operated at a monthly net profit of $1,000. The only consent by any creditor to any priority whatever to MacPhail is the provision that he was to have a prior right of reimbursement *out of the proceeds of the operation of the plant.* There is no provision which even suggests that MacPhail was entitled to or even intended to claim as against those creditors any priority to payment *out of the assets generally* of the Lumber Company. No creditor assented to MacPhail's having any such lien as that. The most that can be said is that *some of the creditors* were willing that he should pay himself back out of profits arising from the operation of the plant if he made any.

We take occasion here again to call attention to the fact that not all the creditors assented even to this extent. See p. 6, *supra.* Only a part of them consented to any arrangement whatever with MacPhail; and this consent was very limited in scope. This, in connection with the fact that the rights which claimant now asserts were not given him *even by his agreement with the bankrupt,* and that if such rights were given him *the whole agreement was thereby rendered void,* is sufficient for the determination of the case.

But we need not rest here. Let us assume for the sake of argument that the conveyance to MacPhail was valid, and that it did actually confer a right of lien. MacPhail has still another bridge to cross.

This brings us to the question of

What Are the Rights of the Trustee in Bankruptcy?

The most that can be said of the conveyance to MacPhail is that it purported *to create a lien* in his favor for subsequent advances. It must therefore be judged by the principles applicable to mortgages or other instruments creating liens. The relevant statutes of the State of Washington are as follows:

Rem. & Bal. Code, Section 3660:

"A mortgage of personal property is void as against creditors of the mortgagor or subsequent purchasers, and encumbrancers of the property for value and in good faith, unless it is accomplished by the affidavit of the mortgagor that it is made in good faith, and without any design to hinder, delay or defraud creditors, and it is acknowledged and recorded in the same manner as is required by law in conveyance of real property."

Section 3661:

"Every such instrument within ten days from the time of the execution thereof shall be filed in

the office of the county auditor of the county in which the mortgaged property is situated * * *."

Section 3668:

"A mortgage of personal property must be recorded in the office of the county auditor of the county in which the mortgaged property is situated, in a book kept exclusively for that purpose * * *."

Section 8781:

"All deeds, mortgages, and assignments of mortgages, shall be recorded in the office of the county auditor of the county where the land is situated, and shall be valid as against bona fide purchasers from the date of their filing for record in said office; and when so filed shall be notice to all the world."

Section 8745:

"All conveyances of real estate or of any interest therein and all contracts creating or evidencing any encumbrance upon real estate shall be by deed."

Section 8746:

"A deed shall be in writing, signed by the party bound thereby, and acknowledged by the party making it, before some person authorized by the laws of this state to take the acknowledgment of deeds."

Section 8782:

"Any mortgage upon property of a mixed character, consisting in part of real estate and in part of personal property, and particularly upon railroad property, in the State of Washington, shall be admitted to record and be recorded in the sev-

eral counties wherein the property is located as a real estate mortgage when acknowledged in the manner provided by law, and the original of such mortgage or a copy thereof certified by the auditor of any county in the State of Washington wherein the original has been recorded may be filed in a file to be kept for that purpose in the office of the auditor of the county wherein such property is situated, and said record and filing shall constitute notice to all persons of the existence of the mortgage lien provided for by said mortgage."

It will thus be seen that the law requires *recording, acknowledgment* and *affidavit of good faith* in order to protect such a lien as this against subsequent creditors, purchasers and incumbrancers.

Authority is hardly needed upon this point; but we make, in passing, brief reference to the following cases:

Mills vs. Smith, 177 Fed. 652 (C. C. A., 9th Cir.).
Smith vs. Allen, 78 Wash. 135 (effect of lack of acknowledgment and recording).
Pacific Coast Biscuit Company vs. Perry, 77 Wash. 353 (effect of failure to record).
Watson vs. First Nat'l Bank, 82 Wash. 65 (lack of recording).
Sligh vs. Sheldon, etc., R. R. Co., 20 Wash. 16 (necessity of affidavit of good faith).
Sayward vs. Thayer, 9 Wash. 22 (affidavit, acknowledgment and recording necessary).

That the trustee in bankruptcy under the 1910 amendment to Section 47-a of the Bankruptcy Act

occupies *the position of a creditor holding a lien* on the property of the bankrupt is too clear to admit of controversy.

We need only to refer to the following cases decided by this court:

Pacific State Bank vs. Coats, 205 Fed. 618, 622.
Meier & Frank Co. vs. Sabin, 214 Fed. 231.
Scandinavian-American Bank vs. Sabin, 227 Fed. 579.
Brandt vs. Mayhew, 218 Fed. 422.

See also:

Re Pacific Electric & Automobile Co., 224 Fed. 220 (D. C. Wash.).
Re Bolstad, 224 Fed. 283 (D. C. Wash.).
Re Bazemore, 189 Fed. 239 (D. C. Alabama).

The *Scandinavian-American Bank* case, 227 Fed. 579, above cited, is similar to the present one in that it involved *a mortgage attempted to be disguised as a trust agreement* which was held invalid as against the trustee.

SUMMARY.

For the sake of clearness we will state our contentions briefly in conclusion as follows:

1. Even *as against the bankrupt* MacPhail could claim priority of payment only *from profits* or moneys realized upon *the sale of the assets by him.* If a greater right of lien was conferred by the instrument it is null and void as (a) opposed to the trust fund theory; (b) a fraudulent conveyance.

2. *No creditor* agreed that he should have a lien *against the assets generally* of the bankrupt. Some creditors consented to his reimbursing himself *out of the profits,* if he could make them, and agreed to extend the time of payment of their claims and desist from pressing them as long as MacPhail could make a profit of $1,000.00 per month.

3. Only *a part* of the creditors assented to the arrangement even to that extent.

4. Even if MacPhail obtained a lien, it is invalid as against the trustee and the creditors.

The case presents no equities favorable to the claimant. He undertook to conduct the business of an insolvent lumber company, and involved both it

and himself in losses. He lost money, but so did many other creditors of the same debtor. From the remarks of the learned district judge in disposing of our petition for a rehearing we gathered the impression that he was influenced in some degree by the assumption that MacPhail acted somewhat in the role of a philanthropist, advancing his money for the benefit of others without hope or expectation of reward. This, if true, we do not believe to be important. But the assumption is a mistaken one. Both in his proof of claim and in the courts below, MacPhail has pressed a supposed claim for interest. Further, he was vice-president of the Willapa Harbor State Bank, which was during the period in controversy a creditor of the bankrupt to the extent of many thousands of dollars (29, 45, 52, 53). Doubtless he hoped to aid his bank. There is nothing wrong in this of course. But he stands on the same footing as anyone else who embarks upon a business venture.

The fact that he expected to be paid in full, upon which the District Court apparently placed some reliance, does not seem material. All the creditors of the bankrupt cherished the same hopeful illusion. The law favors equality of distribution of the losses resulting from a common ruin, in which

many innocent persons have become involved. The establishment of this claim will leave nothing for the payment of demands of other creditors. It is incumbent upon one asserting a right whose establishment will be attended by effects so injurious to others equally guiltless with himself to show clearly that he has complied with the conditions which the law has made precedent to the assertion of such a priority. *Schuyler vs. Littlefield,* 232 U. S. 707, 713; 58 L. Ed. 806, 809.

We believe that a more complete failure than this to show such a right or any right can scarcely be conceived. We respectfully submit that the order of the District Court allowing the claim should be reversed.

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